COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

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Investigation by the Department of)

Telecommunications and Energy on its)

Motion into the Pricing and Procurement) D.T.E. 99-60

of Default Service Pursuant to)

G.L. c. 164, § 1B(d).)

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INITIAL COMMENTS OF PG&E CORPORATION

REGARDING PRICING AND PROCUREMENT OF DEFAULT SERVICE

I. INTRODUCTION

PG&E Corporation ("PG&E Corp.") appreciates having this opportunity to submit comments in response to the Notice of Inquiry/Generic Proceeding into the Pricing and Procurement of Default Service issued by the Department of Telecommunications and Energy ("Department") on June 21, 1999 (the "NOI"). The issue of default service procurement and pricing has been a sleeping giant, temporarily anesthetized by using Standard Offer service pricing as a proxy for the market price on which to base default service pricing. With the issuance of this NOI, the giant is now stirring. The fledgling retail market is filled with apprehension. The destructive potential of a regulated, below-market default service in Massachusetts is unlimited.

In these comments, PG&E Corp. responds to many of the Massachusetts-specific default service issues raised by the Department in its NOI. PG&E's proposed approach works in the Massachusetts context, obviating the destructive potential of the default service giant.[(1)] Under PG&E Corp.'s proposal, default service would operate as a supportive component of the competitive market, consistent with the objectives and requirements of the Massachusetts Electric Industry Restructuring Act.[(2)]

The remainder of these comments is divided into three parts:

- an overview of PG&E Corp.'s view of prerequisites for a competitive market;
- PG&E Corp.'s proposal for default service procurement and pricing; and
- responses to the questions posed by the Department in its NOI.

II. OVERVIEW OF PREREQUISITES FOR COMPETITIVE MARKET

In enacting the Massachusetts Restructuring Act, the Legislature declared that:

[r]atepayers and the commonwealth will be best served by moving from (i) the regulatory framework extant on July 1, 1997, in which retail electricity service is provided principally by public utility corporations obligated to provide ultimate consumers in exclusive service territories with reliable electric service at regulated rates, to (ii) a framework under which competitive producers will supply electric power and customers will gain the right to choose their electric power supplier.[(3)]

PG&E Corp. endorses and shares that vision. Presently, as the Department is well aware, most customers in Massachusetts are still being served principally by public utility corporations at regulated Standard Offer rates. Standard Offer pricing policy has been a matter of great controversy to date. The proper balance point between achieving a "smooth transition" and moving to a competitive market as soon as possible is in the eye of the beholder. However, regulators and competitive suppliers alike can agree that the goal of creating a competitive retail market in Massachusetts remains unrealized. Within each franchise area there are many suppliers willing to sell, but there is functionally only one significant buyer, the incumbent utility. Markets with many sellers but only one buyer are, by definition, not competitive.

PG&E Corp. maintains that in order for consumers to enjoy the many benefits of a competitive retail market, there must be multiple sellers offering multiple buyers a variety of products. Individual consumers have unique preferences for price, reliability, power quality, and other product features. Under the current Standard Offer system, a few regulated utilities are articulating their purchasing preferences to the market in place of the preferences of millions of individuals and businesses. This forces suppliers to cater to the preferences of a few buyers which in turn distorts the wholesale market. It also forces the Department to promulgate more protective mechanisms, monitor performance more carefully and take on the hopeless task of trying to mimic the rational pricing signals naturally developed by a truly competitive market. This problem was succinctly described in a White Paper issued last year by the Electric Power Supply Association ("EPSA"):

Robust, efficient and effective wholesale competition requires access to retail markets. When retail customers are permitted to exercise supply choices among competing alternatives, they create the buyers needed for wholesale markets. Without these customers, wholesale suppliers can sell only to utilities. Retail competition is a critical component of a workable market structure, providing the liquidity, market depth and price visibility essential for robust competition, effective risk management, and desirable capital deployment. While wholesale competition has already brought about benefits to consumers, they are not yet reaping the full benefits of a fully efficient wholesale market, in part because retail competition is not yet in place.[(4)]

The challenge for the Department in designing default service is to unseat the distribution company as the only significant buyer in the wholesale market in its franchise area. It is imperative that the Department take whatever time is necessary to design default service to complement, not inhibit, retail competition.

In considering alternative proposals for default service pricing and procurement, the Department should reflect on what the purpose of default service is and is not. Default service is not the economic safety net needed to help low income customers afford electricity--low income rates are designed to meet that important societal need. The statute makes clear that during the transition period, default service is for new customers, or for existing customers who have chosen a competitive supplier but have stopped receiving that service. G.L. c. 164, § 1B(d). It is not to be an aggregation tool for the incumbent utility. In the following section, PG&E Corp. suggests a design for the pricing and procurement of default service for the Department's consideration which will complement, not inhibit, the development of a competitive retail market.

III. PROPOSAL FOR DEFAULT SERVICE PROCUREMENT AND PRICING

A. Proposal Summary

The pricing and procurement of default service should be a fully integrated process: the procurement process should establish the retail price. The weighted average of the least cost bids to serve the default service load sets the average monthly market price. The price set by the bid process dictates the retail price.

B. Procurement Process

Consistent with the requirements of G.L. c. 164, § 1B(d), each distribution company would administer or cause to be administered[(5)] a competitive solicitation process for the procurement of power to serve its distribution customers eligible to receive default service.

(1) Frequency/Market Differentiation

The frequency for soliciting default service supply would balance the customer acquisition costs, normally incurred in the retail sector, with the volumetric requirements risk assumed by the supplier. The solicitation for "all requirements"[(6)] default service for residential and small commercial default service customers would be issued annually. The solicitation for "all requirements" default service for large commercial and industrial ("C&I") customers would be issued quarterly. The reasons for the different solicitation schedules by load type are as follows:

- In order to reflect accurately the cost of default service for residential/small commercial customers, separate solicitation frequencies should be used. The large C&I load requires a more frequent solicitation process than the residential/small commercial load. The increased frequency is meant to balance the relatively larger volumetric risk with relatively lower cost of acquisition. The proportional difference in the risk/cost ratio means a lower solicitation frequency could materially increase prices.

- Quarterly solicitations for large C&I customers would impose higher transaction costs on bidders, but less than the gain made by reducing the volumetric risks. This frequency would have an additional benefit by sending price signals to the very classes of customers most likely to respond to price signals.

- The residential/small commercial load requires a less frequent solicitation process. The reduced frequency is meant to balance the relatively lower volumetric risk with relatively higher cost of acquisition. The proportional difference in the risk/cost ratio means that a higher solicitation frequency could materially increase prices.

- Annual solicitations for residential/small commercial customers would reduce transaction costs for bidders to a greater extent than the adverse affect of the volumetric risks. This frequency would have an additional benefit of minimizing price changes to those customers least interested in actively participating in the market.

(2) Specification of Components of Default Service

The solicitation document must clearly state what constitutes "supplying default service." All of the commodity and non-commodity costs and risks which default suppliers must assume should be stated explicitly. In PG&E Corp.'s view, suppliers of default service must be exposed to the very same costs and risks as any third party supplier. Achieving such cost/risk parity is absolutely necessary to avoid advantaging default service suppliers relative to other competitive suppliers.[(7)]

In preparing a bid to supply default service, suppliers should include all of the commodity, load managing, and customer care costs associated with providing default service. Bidders should understand that they will be at risk for all such costs. All of the following costs and risks must be borne by the supplier of default service to avoid undermining the competitive retail market:

(a) the cost of the wholesale energy necessary to supply the default service load;

(b) the cost of ancillary services including load shape risk and the related ISO New England responsibilities and costs;

(c) the cost of shaping load (e.g., schedulers and operators);

(d) the cost of customer service including billing and collections;

(e) default risk;

(f) volumetric risk (variations in load due to customer additions and attrition during the contract period);

(g) distribution line losses;

(h) transmission costs, including NEPOOL charges and ISO New England charges, attributable to the default service load;

(i) compliance with the Renewable Performance Standard and Generation Performance Standard;

(j) all other costs imposed by the distribution company on competitive suppliers; and

(k) all other costs of providing default service.

A key by-product of this procurement process will be the market price for providing default service, including all commodity, load management, risk management and customer care costs associated with that service. If the winning suppliers underestimate their cost of providing default service, they will absorb the loss. If the service proves less expensive to supply than the price bid, the suppliers will earn the difference. There will be no deferrals of costs with carrying charges for later collection. The bid price will be the market price. The market price will be the retail price. The distribution company will continue to recover its costs associated with default service; it will not be at risk with respect to those costs.

(3) Role of the Distribution Company

The distribution company should act purely as a conduit for default supply, having no role in marketing or otherwise controlling the power supply for default service. By specifying that default service will be supplied on an "all requirements" basis, the distribution company's role should be limited to ministerial acts unrelated to default service power supply marketing or trading.

C. <u>Pricing</u>

Both G.L. c. 164, § 1B(d) and 220 C.M.R. 11.04 contain three requirements with respect to the pricing of default service:

(1) the rates must be established through competitive bidding;

(2) the rates cannot exceed the average monthly market price for electricity, as determined by the Department; and

(3) customers must have a default service option with a rate which is constant for up to six months.

Starting with the last requirement, it can reasonably be interpreted as prohibiting the fixing of default service rates for longer than six months. Under the PG&E Corp. proposal, the price of default service would be subject to change quarterly for large C&I customers, thus satisfying that requirement. With respect to PG&E Corp.'s proposal for annual solicitations for residential and small commercial customers, the solicitation could require that suppliers offer one price for each of the two six month periods. However, the third requirement could also be read as *requiring* stable rates for periods up to six months as one "option" but *not precluding* longer periods. If that is the interpretation applied by the Department, the annual solicitations for residential and small commercial customers could establish a price for a one year period.

Turning to the other two, interrelated requirements, the Legislature explicitly required that default service pricing be determined via competitive forces, as opposed to using a government-mandated trajectory of prices. By requiring that "in no case shall they exceed the average monthly market price for electricity, as determined by the Department," the Legislature was attempting to prohibit any type of arbitrary or artificial inflation of the prices "established through the competitive bidding process." By letting the market work, the results of each solicitation will appropriately reflect the average monthly market price for electricity to serve default service customers. This approach enables the Department to focus on what it does best--overseeing the propriety of bid processes and enforcing consumer protections--and avoid having to do what the market does better--setting prices.

IV. RESPONSES TO QUESTIONS POSED IN THE NOI

Given that many of the issues raised in the Department's questions have been addressed in PG&E Corp.'s proposal, the responses below will address only those matters not previously discussed above.

1. Is it appropriate at this time to change the way default service is priced (e.g. to separate the pricing of default service from the standard offer price)?

Yes, provided that the Department will allow default service pricing to be set by the market at a level that exceeds Standard Offer pricing.

2. What should be the basis for the "average monthly market price of electricity"? For example, should default service reflect wholesale or retail market costs of electricity? If default service should reflect wholesale prices, what market should provide the basis for the rate (e.g., the wholesale energy market, the wholesale energy and ancillary services markets)? In responding to this question, please be explicit regarding the method for calculating the "average monthly market price of electricity" and/or the default service rate.

As discussed in Section, III.C., infra, the average monthly market price should be established by the competitive bidding process. Bidders must estimate the commodity, load managing, and customer care costs set forth in Section III.B.(2), infra, and price their service accordingly. The winning bids establish the price to consumers. The full bid price must be collected as a pass-through commodity charge; none of the costs should be collected as a distribution charge. By so doing, default service customers will see an accurate price signal with which to evaluate competitive options in the market.

3. If the default service rate should reflect retail prices, how should the rate be determined? For example, should the rate be a benchmark price based on average retail energy prices in Massachusetts or in the region? Should the rate reflect a combination of wholesale prices and

bilateral contracts (e.g., HEFA)? Alternatively should each distribution company establish a default service rate by determining actual or estimated costs associated with the provision of retail services to default customers? In responding to this question, please be explicit regarding the method for calculating the average monthly market price of electricity and/or the default service rate.

The complexity of this question (let alone of the answers) serves as an endorsement of the simplicity and practicality of PG&E Corp.'s approach of letting the market determine the appropriate rate. The rate should be established individually by each distribution company's solicitation process. While the solicitations could produce the result of having all of the rates be the same for a given period, any differences will reflect the market's evaluation of costs to serve customers within each particular franchise area.

4. Does the use of retail market data require that the cost of retail services to default customers be moved from the distribution component of customers' bills to the generation component of customers' bills? If so, how would that best be accomplished?

Please refer to the response to Question 2.

. **5. How should the price be determined? For example, should the price be based on historic market prices or on projected market prices, or should it vary with the actual market price over the course of a month?**

The commodity component of the bid price should be based on a forward looking market price as reflected in the bid for the bid period. Section III.B(2), infra, addresses these issues.

6. How often should default service be competitively procured?

Solicitations for residential/small commercial customers should be issued annually. Solicitations for large C/I customers should be issued quarterly. Section III.B(1), infra, provides the rationale for this recommended frequency.

7. Are there examples from other states that would be useful to the Department in deciding how to determine the default service price?

Yes, there are several instructive examples. They include default service designs in Pennsylvania and in the Atlanta Gas Light service territory, and legislative initiatives in Oregon and Texas.

V. CONCLUSION

PG&E Corp.'s proposal is designed to provide default service to customers which is consistent with Massachusetts' statutory and regulatory requirements, including pricing which will not further impede the development of a competitive retail market. A default service is clearly necessary to guarantee uninterrupted electricity supply to Massachusetts consumers under a variety of circumstances. That safe harbor must be priced, however, in a manner consistent with its costs and risks, not as a permanent paradise providing shelter from market forces. As long as there is a below-market, regulated alternative to competitive power supplies, a competitive retail market will not develop in Massachusetts. PG&E Corp. is confident, however, that if its proposal is adopted, a competitive retail market may be able to develop well before the end of the transition period.

Respectfully submitted,

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Dated: July 14, 1999

1. Other approaches, such as differentiating between core and non-core customers in the design of default service and in the role of the distribution company with respect to core and non-core customers, may be appropriate in other statutory and regulatory contexts.

2. St. 1997, c. 164, An Act Relative to Restructuring the Electric Utility Industry in the Commonwealth, Regulating the Provision of Electricity and Other Services, and Promoting Enhanced Consumer Protection Therein.

3. St. 1997, c. 164, § 1.

4. Electric Power Supply Association, "Retail Electric Competition: Getting It Right!", December, 1998, at 9.

5. Where an electric company has not fully divested itself of its generating assets, the Department should require adequate procedural safeguards to insure the integrity of the default service bidding process.

6. "All requirements" means that the amount to be supplied may increase or decrease in volume due to customers leaving or being added to default service. The obligation to supply would change proportionately for each supplier.

7. A method for assuring parity in the market place is to make default service available to competitive suppliers as well as customers.